

Zero-Cost/Zero-Cash Cylinder Option for currency buyers

The situation

You are in business importing from England and you will be paying money out in Sterling over the next 6 months. You are happy with the current exchange rate, but you think the Sterling might lose value during the period and you do not want to commit yourself today to a fixed forward contract for the future. You have thought about an FX Option, which would be very suitable for your situation, but you are unwilling to pay the cash premium up front.

The product

A Zero-Cost Cylinder might be the answer in your situation. A Zero-Cost Cylinder involves buying a Sterling Call Option and selling a Sterling Put Option. By buying the Sterling Call Option you protect yourself against Sterling becoming much stronger. The Sterling Call Option gives you the chance to make unlimited 'windfall' gains when the Sterling is weak. You can choose to give up some of this possible windfall by selling a Put Option to the bank at a set level, which would allow us to sell Sterling to you at an improved price over the current spot rate. When the Put Option you sell has the same premium value as the Call Option you buy, this is known as a Zero-Cost Cylinder.

The solution

You want to protect the USD cost of the Sterling payments you must make in the next 6 months. The forward rate is 1.40 but you have budgeted for a rate of 1.45, and it is this level you want to protect. You arrange a Zero-Cost Cylinder with us. The cylinder involves you buying a Sterling Call Option at 1.45 (allowing you to buy your Sterling from us at this rate and protecting your budget target) and you selling to us a Sterling Put Option at 1.35. Your firm then has to buy Sterling from us at 1.35, if this rate is reached. This means a possible improvement of 5 cents but gives up the possibility of you benefiting from any further weakness in the Sterling beyond 1.3500.

The value of the option sold is the same as the value of the option you have bought. This involves no up front cash cost and guarantees that you can buy your Sterling at some price between 1.35 and 1.45.

The benefits

- The cylinder offers you some protection when the pound is particularly strong.
- The cylinder allows you to benefit when the pound is weak.
- You do not need to pay a premium.
- You can reverse the cylinder at any time.

Features

- We provide Zero-Cost Cylinders for all currencies that can be exchanged for USD
- The cylinder is available for most maturities - but generally lasts no longer than 12 months.
- We can change the structure slightly so that the option you sell has a greater or lesser value than the option you buy. A cylinder is still created but you may either have to pay a small premium or you may receive a small premium.